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IN THE

Supreme Court of the United States

October Term, 1930.

No. 199.

DAVID BURNET, Commissioner of Internal Revenue,
Petitioner,
vs.
SAMUEL F. HOUSTON,
Respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

MOTION FOR LEAVE TO APPEAR AND FILE A BRIEF AS AMICUS CURIAE, AND BRIEF.

JAMES CRAIG PEACOCK,
Counsel for Mrs. J. I. R. Henry, Executrix of the will of Bayard Henry, Deceased.

GERALD RONON,
Of Counsel.

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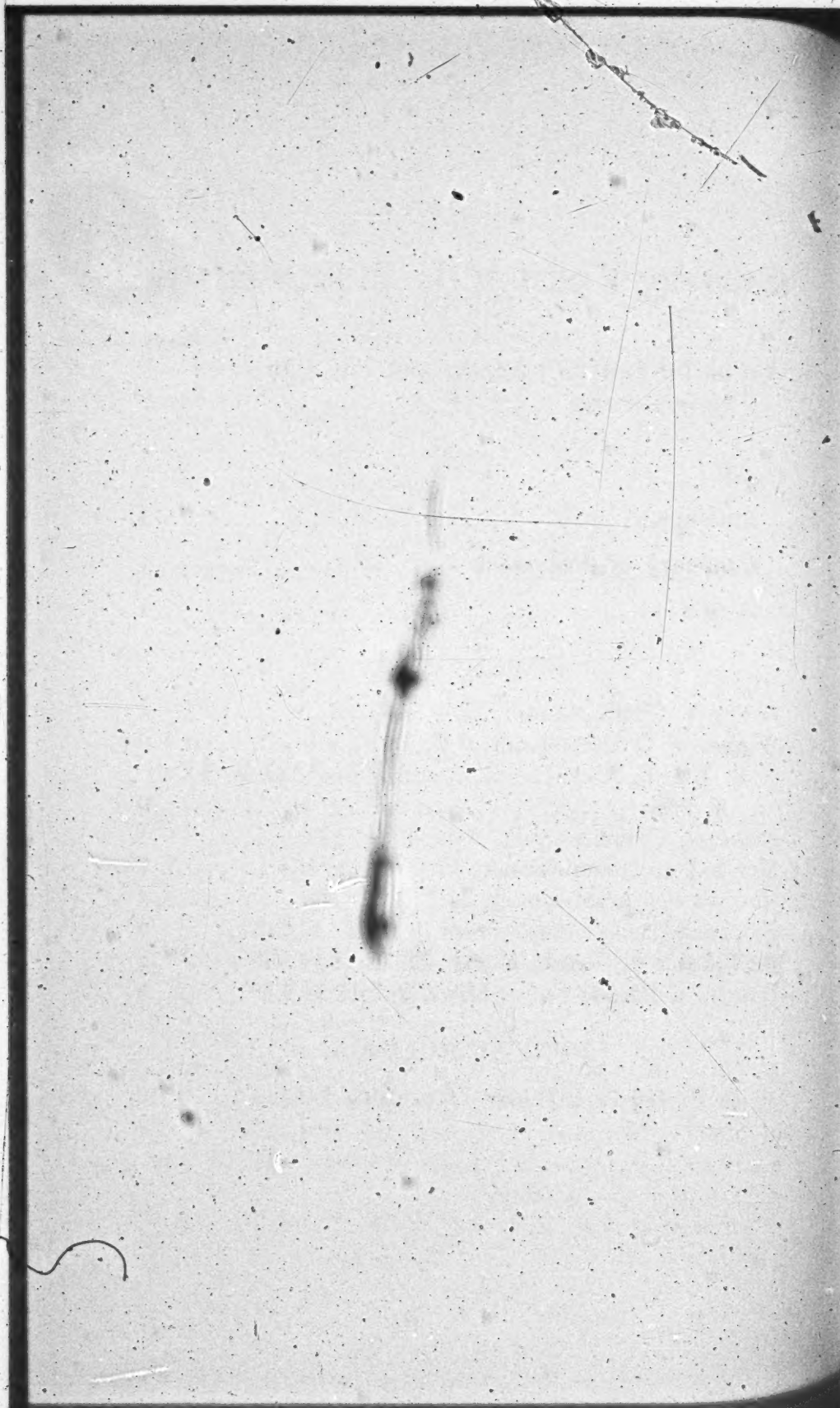

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MOTION FOR LEAVE TO APPEAR AND FILE A BRIEF AS AMICUS CURIAE.

Now comes James Craig Peacock of Washington, D. C., counsel for Mrs. J. I. R. Henry, executrix of the will of Bayard Henry, deceased, and presents this his motion for leave to appear and file a brief in the above-entitled cause as *amicus curiae*, and in support of this motion shows:

An appeal filed with the United States Board of

Tax Appeals by the late Bayard Henry (who died September 17, 1926, and whose executrix, J. I. R. Henry, was thereupon substituted as petitioner) arose out of the same facts and involved identically the same issue as the three cases which are now before this court as Nos. 199, 202, and 203. All four cases were consolidated for trial before the Board and were tried and decided together (R. 9, 10). The complete facts and figures in the case of Bayard Henry will be found included in the record in the present case (R. 9-14, 22-23, 33, 41). The appeal of Bayard Henry having been filed with the Board prior to the passage of the Revenue Act of 1926, his executrix elected to pay the additional tax with the right to file a claim for refund and a suit in the District Court instead of filing a petition for review in the Circuit Court of Appeals as was done by the other three taxpayers whose cases are now here on the Government's petitions for certiorari. Mrs. J. I. R. Henry, as executrix of Bayard Henry, has, however, just as direct an interest in and will be just as directly affected by the decision of this court as any of the parties in Nos. 199, 202, and 203.

WHEREFORE, it is prayed that an order be entered permitting James Craig Peacock to appear as *amicus curia* in the above-entitled case, with leave to file the brief attached hereto.

Respectfully submitted,

JAMES CRAIG PEACOCK,
Counsel for Mrs. J. I. R. Henry, Executrix of the will of Bayard Henry, Deceased.

GERALD RONON,
Of Counsel.

BRIEF.

STATEMENT

The facts are correctly enough presented in the Government's brief *with the exception of one serious omission.* The reorganization plan did not include merely "the creation of a fund of $2,500,000 from subscriptions by directors of the company" as it is described in lines 8 and 9 on page 3 of the Government's brief. It was expressly found by the Board of Tax Appeals that "the creation of a fund of $2,500,000 from subscriptions by directors of the company" was "to *guarantee* a value of $3,000,000 for the Segal collateral, designated in the plan 'Segal matters'" (R. 11). The Board also found on each page of its findings that the fund was "the *guaranty* fund" (R. 11, 12, 13, 14).

We unqualifiedly concur in the decision of the Circuit Court of Appeals that the amount of each subscriber's loss had been properly determined in his original return as the difference between his subscription to "the guaranty fund" in 1906 and the value of his prorata share of the proceeds of that fund when received by him in 1920 or 1921 (R. 63). We likewise fully concur in the reasoning whereby that court below reached that conclusion.

We feel, however, that for a still further and entirely independent reason, which arises out of this transaction being one *of guaranty* and which was not considered by the court below, the same conclusion must also and inevitably be reached. That is the only occasion for the present brief, which will be strictly confined to consideration of that one further reason

why the judgments in No. 199 and the two related cases should be affirmed.

Summary of Argument

That further reason is that the transaction was essentially *one of guaranty* and for income tax purposes its status as such can not be ignored. It has already become established, and correctly so, that for such purposes a guarantor's loss is wholly sustained at the time when the transaction is closed and in the amount by which he is actually out of pocket. These principles require that the decision of the court below should be sustained.

Argument

First as to the facts. This case is before this court on the findings of fact made by the Board of Tax Appeals and printed at R. 10-14. The Board expressly found that the purpose of the fund in question was "to guarantee a value of $3,000,000 for the Segal collateral" (R. 11), and equally as expressly and at least six times in the course of its comparatively short findings found the fund to be "the guaranty fund" (R. 11, 12, 13, 14). These findings are conclusive and are not subject to court review where as here the only issued raised is one of law. *Avery v. Commissioner,* 22 F. (2d) 6; *Robichaux v. Commissioner,* 32 F. (2d) 780; *Powers v. Commissioner,* 34 F. (2d) 255. The court below at least nine times in its opinion similarly characterized the fund as "the guaranty fund" (R. 57, 58, 60, 63) and also referred to the loss as "the loss of a guarantor" (R. 62). Our position is also well within the scope of paragraphs 5,

6, and 7 of the original assignments of error (R. 19).

So much for the facts. A "guaranty" by its very nature inevitably contemplates liability or obligation, and yet we vainly search the Government's petition for certiorari or either of its briefs for even the slightest reference to that aspect of the case. There is nothing but reference after reference to the taxpayer's "right" to share in the proceeds and to his "property", his "property interests", and his "property right." All of which may be true, for even a guarantor has rights. But it is far from the painting of a complete picture. The transaction was essentially and through all the years one of guaranty *and the Board has so found.* A guaranty is essentially an obligation, and the principles applicable to such transactions have become quite well established in a line of cases to which we will briefly refer. These decisions indicate beyond question that a loss of a guarantor or endorser is sustained wholly and only when the transaction is finally closed, and thus fully support the decision of the Circuit Court of Appeals that in the present case March 1, 1913, is not a controlling date nor March 1, 1913, value an essential factor.

The case most closely in point on its facts is that of *McLeod v. Commissioner*, 19 B. T. A. 134. McLeod was a stockholder and director in the Fidelity Trust Company which the Massachusetts Commissioner of Banks in 1920 took over and proceeded to liquidate. A substantial part of the assets were sold to the Liberty Trust Company under an agreement whereby the liquidation of a part of the assets so purchased should be in the hands of a board of trustees, and if the total amount realized should exceed the obligations and liabilities assumed by Liberty such excess should

be distributed among the stockholders of Fidelity. One of the conditions of the agreement was that a *guaranty fund* of $400,000 should be raised by the stockholders and deposited with the trustees. This condition was complied with and for several years there seemed to be hope that the assets would be liquidated at an amount which would enable the trustees to refund to the subscribers to the guaranty fund a portion of the amount of their subscriptions. McLeod paid approximately $20,000 on his subscription to the guaranty fund, the principal payments being $5,000 in October, 1923, $8,000 in April, 1924, $4,500 in October, 1924, $1,000 in November, 1924, and $1,000 in January, 1925. The first of these payments was an initial cash payment, and the others were in payment of notes which he had given as security for the balance of his subscription. McLeod claimed a deduction in his fiscal year ending June 30, 1925, for the loss on his subscription to the guaranty fund. The Board said at page 138—

> "The respondent contends that any loss which the petitioner sustained with respect to his subscription to the guaranty fund was a loss in the fiscal year ended June 30, 1924, and that no part of that loss may be allowed either as a bad debt deduction or as a loss in the fiscal year ended June 30, 1925."

After holding that there was no debtor or creditor relationship between the trustees and McLeod the Board continued at page 139—

> "The respondent has determined that the petitioner sustained no loss upon this transaction in the fiscal year ended June 30, 1925. The peti-

tioner has adduced evidence to the effect that he had not ascertained that he had sustained a loss in respect of his subscription to the guaranty fund until May or June, 1925. But an ascertainment of a loss within a taxable year is not the criterion imposed by the statute for a loss deduction. Losses are deductible under the statute only in the year when *sustained.* The evidence here does not show, in the language of the Supreme Court in United States v. White Dental Mfg. Co., 274 U. S. 398, the occurrence in the fiscal year ended June 30, 1925, of "indentifiable event" which fixed a loss deductible from gross income. *If the evidence showed the liquidation* by the Liberty Trust Co. or of the trustees *of the assets of the Fidelity Trust Co.* taken over *and a deficiency resulting from that liquidation in the taxable year under review, it might be that the loss suffered by the petitioner would thereby be identified as a loss sustained in the taxable year.* But the respondent has determined that the loss was sustained in a prior taxable year. The evidence offered does not prove or tend to prove error on the part of the respondent in making such determination. The contention of the respondent is therefore sustained."

In that case it was held that a guarantor's loss on a subscription to a guaranty fund is sustained when and only when the transaction is finally closed by liquidation of the assets guaranteed. There was no talk of "rights" or of "property" in that case, and no more need there be in the present case. The Board clearly recognized that a deficiency resulting from the liquidation of the assets was the measure of the loss, and that the loss was sustained when that liquidation took place. It so happens that all the events in the *McLeod* case were subsequent to March 1, 1913,

but even had the guaranty fund been created before that date the principle announced by the Board would necessarily exclude the application of any March 1, 1913, value theory, the very essence of which is that a part of the loss had already been sustained by that date. If the principles decided in the *McLeod* case apply in the case of a guaranty fund when the result of their application is favorable to the Government, they would seem equally applicable in the present case.

The case of *Dillon v. Commissioner*, 9 B. T. A. 174, is perhaps even more closely in point in its principle. There the Board allowed a loss as a deduction to certain guarantors when they made a payment of $28,000 in accordance with a later agreement under which that payment was to be made in full release of their liability under an earlier guaranty. In that case as in the present case the guaranty was finally closed out in *accordance with* a supplemental agreement, and the Board held that the loss was deductible *when and only when the matter was finally closed.* As it said at page 180 in the case of guarantors of stock values (and the present contributors were in the same way guaranteeing the values of the Segal matters)—

> "Under such facts, losses are not realized until the corporation becomes insolvent or the stock worthless * * * *A guarantor's loss depends upon whether the obligations guaranteed proved to be worthless in whole or in part.*"

These two cases make it plain that in the case of a guaranty the loss is sustained—not from time to time as the matter proceeds and hence measured by com-

parison with a March 1, 1913, value—but only when it is closed by final and irrevocable settlement of the guarantor's liability. Until then there is no loss at all. Usually the final settlement is by a cash payment, but the form is a mere incident and not a substantial or controlling factor. The mere fact that, as here or as in the *McLeod* case, the cash may have been previously paid subject to refundment to the extent not eventually needed, can obviously not be the determining factor. This is in full accord with another well established line of cases giving effect in one form or another to the basic principle that for income tax purposes it is immaterial which party may actually hold the custody of funds pending final determination of who is entitled thereto. *Bugher v. Commissioner,* 9 B. T. A. 115; *Reizenstein v. Commissioner,* 9 B. T. A. 1184; *C. R. I. & P. Rwy. Co. v. Commissioner,* 13 B. T. A. 988. Cf. also *Southern Pacific Company v. Lowe,* 247 U. S. 330, 337.

That a March 1, 1913, value is not a factor in a case of a loss by a guarantor or endorser, and that such a loss is wholly sustained in the year when the matter is finally closed even though both the endorsement and the insolvency of the debtor occurred prior to March 1, 1913, is specifically held in a published ruling of the Commissioner of Internal Revenue. We refer to A. R. R. 479, reported in Internal Revenue Cumulative Bulletin No. 5, page 146.

In that case the taxpayer had endorsed certain notes of the corporation and as a result of the corporation becoming insolvent had become liable as endorser for payment of the notes. *All of this happened prior to March 1, 1913.* He did not, however, make any settlement on account of this liability, either

in cash or in his own notes, until 1917, and in that year he deducted as a loss the amount which he then paid. The Income Tax Unit disallowed the loss on the ground that the payments were made in liquidation of a liability incurred prior to March 1, 1913, or in other words that the loss was sustained prior to that date, just as in the present case the Government argues that Mr. Houston's loss was sustained prior to that date. But the Bureau's Committee on Appeals and Review, in a ruling approved and officially published by the Commissioner of Internal Revenue, held—

> "In the opinion of the Committee, A suffered no actual loss through his indorsement of the said notes until he made his first payment in liquidation of their principal and interest thereon. When a payment was made it created a debt in his favor due from the makers of the notes, which debt was at the time it was created definitely known to be worthless and uncollectible. Each additional payment created an additional bad debt.
>
> In view of the foregoing the Committee recommends that the action of the Income Tax Unit in disallowing the deductions claimed by A for the years 1917, 1918 and 1919 to cover amounts paid in liquidation of the said notes and interest thereon be reversed, and that the said deductions be allowed in the amounts as claimed."

In other words, this ruling absolutely confirms our position that such a loss is for income tax purposes sustained in its entirety only when the matter is finally closed either by payment or by final release of all or part of amounts already in the custody of the other party. It is apparent that in the case of

the taxpayer in A. R. R. 479 the value of any "rights" that he might have had in the matter on March 1, 1913, was just as negligible as the value which the Government seeks to attribute to Mr. Houston's "rights" at that date. The Government has however, through its duly authorized agency ruled that the theory of March 1, 1913, valuation does not apply in such a case, and unless it was clearly wrong in that case—and we feel sure that it was not—it cannot now be heard to argue that such a theory is applicable in the present case.

Let us assume for a moment that the income tax had been in effect as long ago as 1906, and ask ourselves the question whether any of the subscribers to the guaranty fund had sustained any loss on account of the Segal matters either in that year or at any time prior to March 1, 1913? The answer must obviously be a negative one. The Segal matters still belonged to and continued to belong to the Real Estate Trust Company. They were still being administered by that company, and continued to be so administered until many years after 1913. During many of those years there was still substantial ground and hope that the Segal matters would liquidate at or even in excess of the value guaranteed by the subscribers. In the event of that happy outcome the subscribers would never sustain any loss. It would indeed be a stretching of theory to its very breaking point to say, as the Government now claims before this court, that a guarantor's loss, which is admittedly not deductible until his account with the guaranty fund is closed, should nevertheless be limited to the value of his "right" on a date years earlier when

there was no sure way of knowing whether there would ever be any loss.

Or to look at it another way. If in 1906 Bayard Henry had merely guaranteed the Segal matters up to $42,500 without actually putting up the cash until 1921, when to use the words of the Board in the *Dillon* case "the obligations guaranteed prove to be worthless * * * in part," and had then paid up his loss of $36,950, would there be any question that the entire loss was both sustained and deductible in that year? Nor can there be any real question here. The guiding principles applicable to cases of guarantors or endorsers have been too well settled in such decisions of the Bureau of Internal Revenue and of the Board of Tax Appeals as those which we have quoted. It has apparently been unnecessary for the higher courts to pass upon them except in just such isolated cases as those now before this court where the initial decision was out of line with the general trend of the decisions of the Bureau and of the Board. We venture the suggestion that the principles expressed and embodied in the rulings cited will be found by this court to be so sound and convincing that there will be no occasion to disturb the judgment which has been entered in this case by the Circuit Court of Appeals.

Respectfully submitted,

JAMES CRAIG PEACOCK,
Counsel for Mrs. J. I. R. Henry, Executrix of the will of Bayard Henry, deceased.

GERALD RONON,
Of Counsel.